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Comments on Proposed Interagency Advisory Concerning
Alternative Dispute Resolution and Limitation of Liability Provisions
in External Audit Engagement Letters

Dear Sir or Madam:

Ernst & Young LLP is pleased to provide this response to the proposed advisory issued by the Federal Financial Institutions Examination Council ("FFIEC") concerning "the Unsafe and Unsound Use of Limitation of Liability Provisions and Certain Alternative Dispute Resolution Provisions in External Audit Engagement Letters" (the "Proposed Advisory").[1]

Our firm serves as independent auditor for more than 200 insured depository institutions with combined assets of more than $1.5 trillion. The Proposed Advisory addresses matters of great importance to us and our clients, and we appreciate the opportunity to offer our comments.

## I. INTRODUCTION

As a fundamental matter, we agree that financial statement audits, as a complement to government examinations, play an important role in promoting the safety and soundness of financial institutions. Accordingly, we believe that provisions in audit engagement letters between external auditors and financial institutions that would impair audit effectiveness, or the objectivity and impartiality of auditors, should be prohibited. We also believe that financial institutions, like other businesses, should reject contract terms that are not commercially reasonable or are otherwise inappropriate.

However, we also believe that contractual alternative dispute resolution provisions of the type discussed in the Proposed Advisory ("ADR" or "ADR provisions") — as well as some, but not all, limitations of liability ("LoLs" or "LoL provisions") — are fully consistent with safety and soundness. In our view, such provisions pose no risk to financial institutions, but instead serve the commercially reasonable goals of creating certainty in business arrangements and reducing litigation-related costs. We believe such provisions should be encouraged, rather than prohibited

1 70 Fed. Reg. 24576 (May 10, 2005).

or discouraged.

Our specific comments on the Proposed Advisory fall into four principal categories.

*First,* we suggest that the discussion of ADR in the Proposed Advisory be removed. We believe that the fact that the Proposed Advisory addresses both LoL and ADR provisions suggests, incorrectly, that these provisions are similar. In our view, ADR and LoL provisions are very different, and discussing the two together is confusing. Further, we believe the substance and tone of the ADR discussion are inconsistent with the federal policy favoring arbitration, previous guidance from the agencies, and the widespread use of ADR in the banking industry.[2]

We believe it would be helpful for the notice accompanying any final advisory to explain why the ADR discussion was deleted and reaffirm the agencies' support for ADR. Further, because ADR provisions sometimes include LoLs, a final advisory might logically point out that LoLs should be evaluated on the same basis whether they are stand-alone clauses or part of an ADR provision. But otherwise, we believe there is no reason for a final advisory to discuss ADR. Any such advisory should focus instead on the separate subject of LoLs.

*Second,* we suggest that any final advisory should distinguish between those LoL provisions that present an abnormal risk of loss to a financial institution and those that do not. In particular, we submit that mutual waivers of punitive damages, which do not affect an institution's ability to recover for losses suffered, which protect institutions (as well as their auditors) from potentially enormous punitive damage claims, and which do not preclude recovery by third parties, are fully consistent with safety and soundness.

*Third,* we suggest that FFIEC and the agencies should consider carefully whether the Proposed Advisory, if adopted, could have the unintended and counterproductive effect of making it more difficult, or more expensive, for some financial institutions to obtain audit services.

*Finally,* we respond to certain specific requests for comments.

## II. APPLICABLE REGULATORY PRINCIPLES

The Proposed Advisory is premised on the agencies' power to prohibit unsafe and unsound practices. As FFIEC and the agencies are aware, such practices are not defined by statute. Rather, the standard for assessing whether a practice is "unsafe and unsound" has been developed and interpreted by the courts. The courts have defined an "unsafe and unsound" practice as "any action, or lack of action, which is contrary to generally accepted standards of prudent operation, the possible consequences of which, if continued, would be abnormal risk of loss or damage to an

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2 Although there are a variety of forms of ADR, the Proposed Advisory is limited by its terms to binding ADR provided for in connection with audit engagement letters. Arbitration is the leading form of binding ADR and, except for jury trial waiver, is to our knowledge the only binding form of ADR that is commonly specified in audit engagement letters.

Non-binding forms of dispute resolution, such as mediation or non-binding arbitration, can also be valuable tools. However, because they do not provide finality, they are not a substitute for litigation.

institution, its shareholders, or the agencies administering an insurance fund."[3] An unsafe or unsound practice thus has two components: "(1) an imprudent act (2) that places an abnormal risk of financial loss or damage on a banking institution."[4]

The Proposed Advisory states that:

> [t]he inclusion of limitation of liability provisions in external audit engagement letters and other agreements that are inconsistent with this advisory will generally be considered an unsafe and unsound practice. The Agencies may take appropriate supervisory action if such provisions are included in external audit engagement letters or other agreements related to financial statement audits . . . .[5]

Under principles of judicial review, any "supervisory action" based on the Proposed Advisory would be set aside if found to have been "arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law."[6] Although a court would extend deference to the agency, such deference would not preclude "a thorough, probing, in depth review."[7] To survive judicial scrutiny, the agencies must "examine the relevant data and articulate a satisfactory explanation for its action including a 'rational connection between the facts found and the choice made.'"[8]

Accordingly, we suggest that the Proposed Advisory, like any regulatory proposal by the agencies, should focus on practices that are reasonably determined to pose an abnormal risk of loss to a financial institution, based on an appropriate factual record. We see no such record in the Proposed Advisory. As drafted, the Proposed Advisory does not set forth facts concerning the prevalence or effect of ADR or specific LoL provisions, from which a rational connection to the agencies' proposed policy choices might be established.

## III. GENERAL COMMENTS

### A. The Proposed Advisory Should Focus On Limitation Of Liability Provisions, And The Discussion Of ADR Should Be Removed

Our initial general comment is that, in our view, the discussion of ADR in the Proposed Advisory should be removed.

As currently drafted, the Proposed Advisory focuses primarily on LoL provisions, as opposed to ADR. There is no mention of ADR in the background section of the notice, in the list of questions on which the agencies are seeking comment, in the Purpose or Background sections of

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3 *MCorp Fin., Inc. v. Board of Governors*, 900 F.2d 852, 863 (5th Cir. 1990), *aff'd in part, rev'd in part on other grounds*, 502 U.S. 32 (1991).

4 *Seidman v. Office of Thrift Supervision*, 37 F.3d 911, 932 (3d Cir. 1994).

5 70 Fed. Reg. at 24579.

6 5 U.S.C. § 706(2)(A), (B), (C), (D).

7 *Citizens to Preserve Overton Park v. Volpe*, 401 U.S. 402, 415 (1971).

8 *Motor Vehicle Mfrs. Ass'n v. State Farm Mut. Auto. Ins. Co.*, 463 U.S. 29, 43 (1983) (quoting *Burlington Truck Lines, Inc. v. United States*, 371 U.S. 156, 168 (1962)).

the Proposed Advisory, or in the examples set forth in Appendix A. Only at the end of the advisory, just before the conclusion, is there a brief section discussing ADR.

In our view, appending a discussion of ADR to an advisory that is focused primarily on LoLs is confusing. The two types of provisions actually have little in common. LoL provisions limit the potential recovery of a party to a dispute in some manner. ADR provisions, by contrast, address only the process by which substantive rights will be determined.[9] Such provisions do not take away rights; they merely reflect the parties' choice of a method for resolving a dispute.

We believe that interposing a discussion of ADR into an advisory that is first and foremost about LoLs causes the critical differences between the two types of provisions to be obscured.

We are also concerned about the ADR discussion for another reason: in our view, the discussion is both inaccurate (or at best potentially misleading) and inconsistent with the federal policy favoring arbitration, previous agency pronouncements, and the widespread use of arbitration in American and international commerce, including in the banking industry.

For these reasons, we believe it is important that the ADR discussion be removed from the Proposed Advisory. We do think it would be helpful for the notice accompanying any final advisory to explain why the ADR discussion was deleted and reaffirm the agencies' support for ADR. Moreover, in light of the fact that LoLs are sometimes included in ADR provisions,[10] a final advisory might appropriately note that impermissible LoL provisions are equally impermissible when they appear as part of ADR. Otherwise, however, we see no need for ADR to be addressed in an advisory at all because we do not believe that ADR poses any special risk.

1. *ADR Is Favored By Federal Policy, Is Widely Used By Financial Institutions, And Has Been Endorsed By The Agencies*

Eighty years ago, Congress established a federal policy favoring ADR by enacting the Federal Arbitration Act. Before the Act, binding agreements to arbitrate future disputes were disfavored. The Act reversed this presumption, providing expressly that agreements to arbitrate should be treated the same as any other contractual provision.[11]

In a series of cases spanning more than twenty years, the U.S. Supreme Court has expressly acknowledged the federal policy favoring arbitration and has warned that agreements to arbitrate should not be viewed with suspicion.[12] The use of arbitration to resolve disputes has

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9 As noted below, LoL provisions vary widely in scope and effect. *See* pp. 8-9, *infra.*

10 *See* 70 Fed. Reg. at 24579.

11 See 9 U.S.C. § 2. Although parties have always had the right, in theory, to agree to arbitrate a dispute *after* it arises, it is often difficult for disputing parties to agree on anything, including a dispute resolution process. Pre-dispute agreements permit the parties to consider how best to resolve potential disputes before tensions arise.

12 *See, e.g.*, *Green Tree Fin. Corp. v. Randolph*, 531 U.S. 79, 89-90 (2000) (Court has "rejected generalized attacks on arbitration that rest on 'suspicion of arbitration as a method of weakening the protections afforded in the substantive law to would-be complainants' "); *Gilmer v. Interstate/Johnson Lane Corp.*, 500 U.S. 20, 26 (1991) ("by agreeing to arbitrate . . . a party does not forego the substantive rights afforded

been held fully acceptable for resolving important statutory claims, including in the securities, employment and antitrust contexts.[13]

ADR has been widely used in American and international commerce for many years, and the banking industry is no exception.[14] Indeed, previous agency pronouncements have recognized and even encouraged the use of ADR. For example:

- The Statement of Policy on Use of Binding Arbitration issued by the Federal Deposit Insurance Corporation ("FDIC") describes the FDIC as a "strong advocate" for arbitration and advises that arbitration can help the FDIC "accomplish its business in an efficient, economical and productive manner." This Statement of Policy notes that "potential benefits of arbitration are its greater flexibility, potential for limited discovery and streamlined hearing processes, use of panels of trained subject-area expert arbitrators, and restricted judicial review rights."[15]
- The Interagency Policy Statement on the Internal Audit Function and its Outsourcing issued in March 2003 provides that all written contracts between vendors and financial institutions shall "prescribe a process (arbitration, mediation or other means) for resolving disputes and for determining who bears the costs of consequential damages arising from errors, omissions and negligence."[16]
- Consistent with its stated policy, the FDIC has included arbitration provisions in its own contracts with financial institutions. During the savings and loan crisis, for instance, the FDIC entered into loss-sharing arrangements with a number of banks, as an alternative to traditional purchase and assumption transactions, to resolve 24 failed institutions. Under this loss-sharing program, disputes between the FDIC and an acquiring bank that could not be resolved through good-faith negotiations were submitted to arbitration.[17]

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by the statute; it only submits to their resolution in an arbitral, rather than a judicial forum"); *Mitsubishi Motors Corp. v. Sole Chrysler-Plymouth, Inc.,* 473 U.S. 614, 626-27 (1985) ("we are well past the time when judicial suspicion of the desirability of arbitration and of the competence of arbitral tribunals inhibited the development of arbitration"); *Moses H. Cone Memorial Hosp. v. Mercury Constr. Corp.,* 460 U.S. 1, 24 (1983) (noting "liberal federal policy favoring arbitration agreements");.

13 *See, e.g., Gilmer*, 500 U.S. at 26 (age discrimination); *Shearson/American Express Inc. v. McMahon*, 482 U.S. 220 (1987) (securities and racketeering); *Mitsubishi Motors,* 473 U.S. at 632 (antitrust).

14 In banking, arbitration clauses are widely used in loan agreements with borrowers, credit card agreements with consumers, and inter-creditor agreements. They have "become a significant part of lending practice. The logic behind them is that they avoid the time, expense and headache of litigation which is to the advantage of lenders and consumers alike." James Peterson, *Arbitration Clauses Under Fire*, ABA Banking J. (July 2000) (quoting Michael Crotty, American Banking Association deputy general counsel).

15 FDIC, *Statement of Policy on Use of Binding Arbitration*, 66 Fed. Reg. 18632 (April 10, 2001).

16 *Interagency Policy Statement on the Internal Audit Function and Its Outsourcing,* OCC 2003-12 (Mar. 17, 2003).

17 FDIC, *Managing the Crisis: The FDIC and RTC Experience 1980-1994*, at 197, 203 (1998).

### 2. *The Proposed Advisory's Approach To ADR Is Inappropriate In Light Of Federal Policy, Agency Pronouncements And Industry Practice*

Although the Proposed Advisory does not prohibit the use of ADR, it discusses the subject in a negative manner. Moreover, we believe that much of what the Proposed Advisory has to say about ADR is inaccurate or, at a minimum, potentially misleading. Indeed, the very act of singling out ADR as a subject of concern is arguably at odds with the Federal Arbitration Act's mandate that arbitration terms be treated the same as other contract provisions.

*First,* a financial institution's decision to agree to arbitration rather than risk the outcome of a jury trial does not impair the value of a potential claim, as the Proposed Advisory suggests. The Supreme Court has made it clear that an arbitration agreement, standing alone, does not impair any substantive right of a party and does not decrease the deterrent effect of applicable law.[18]

Moreover, if an ADR agreement had any effect on the value of a claim, it could just as easily *increase* the value of the claim as decrease it. A jury trial exposes both the financial institution and the auditor to certain risks that might not be present in an ADR setting, such as the risk arising from the fact that a jury may lack experience with complex business practices, or the risk of a costly and time-consuming legal proceeding in court.

*Second,* it is not accurate to suggest, as the Proposed Advisory does, that by agreeing to ADR a financial institution is *necessarily* disadvantaged by giving up discovery rights, appellate review, or other "protections" that the institution would have in court. In fact, one of the benefits of ADR is that agreements can be tailored to address the particular needs and concerns of the parties. If the parties so desire, specific provisions can be included in an ADR agreement to address the extent of discovery, to provide a mechanism for appellate review, and even to mandate other procedures, such as the use of evidentiary rules, that are generally available in court.

Moreover, even where ADR provides a process that is more streamlined than in court, the Supreme Court has rejected the notion that a process is inappropriate simply because it does not provide all of the procedural bells and whistles that would be available in court.[19] Indeed, the ability to choose a process that is less complex, and therefore less expensive, is one of the attributes that makes ADR attractive to many users, including the FDIC.[20]

Similarly, both an auditor and financial institution may sensibly opt to have disputes heard by a judge without a jury. "Bench trials" are typically more streamlined than jury trials and may be less encumbered by procedural rules, resulting in significantly shorter and less expensive proceedings. Both the auditor and financial institution may opt for a bench trial because they

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18 *See Gilmer,* 500 U.S. at 26, 28; *Mitsubishi Motors,* 473 U.S. at 628.

Similarly, the Proposed Advisory's suggestion that "by waiving a jury trial, the financial institution may effectively limit the amount it might receive in any settlement of its case" (70 Fed. Reg. at 27579) is unsupported. Presumably, a financial institution with a valid claim against its auditor should be able to persuade arbitrators or a judge of that fact at least as easily as it could persuade a jury.

19 *See, e.g., Gilmer,* 500 U.S. at 30; *accord Green Tree*, 531 U.S. at 89-90.

20 *See* FDIC, *Statement of Policy on Use of Binding Arbitration, supra* note 15.

reasonably conclude that a judge experienced in deciding complex disputes may be a more appropriate decision-maker than a jury of laypersons.

*Third,* although the Proposed Advisory indicates that ADR agreements with auditors are something new, such agreements have been regularly included in many audit engagement letters for at least a decade. In that time, we are not aware of any financial institution that has suffered a loss because of an ADR provision. To the contrary, the widespread use of ADR by financial institutions — and the fact that arbitration and bench trials are generally more efficient and less expensive than jury trials — suggests that, if anything, ADR is a plus for such institutions.

*Fourth,* it should be noted that professional auditing standards, applicable to both public and private companies, already address ADR. These standards provide that an agreement between an auditor and a client to use ADR in lieu of litigation does not impair independence.[21]

*Finally,* it bears repeating that the agencies, and the FDIC in particular, have previously endorsed the use of ADR in strong terms. It would be odd, to say the least, if the FDIC could use ADR to "accomplish its business in an efficient, economical and productive manner"[22] while effectively prohibiting other entities that deal with financial institutions from doing the same.

Of course, it is only common sense that financial institutions — like other businesses — should understand completely the terms and conditions of the legal agreements they enter into with other parties. However, we do not believe there is any legitimate regulatory reason to single out ADR agreements for special treatment.

### 3. *Any Discussion Of ADR In The Proposed Advisory Should Focus On Unfair And Coercive Provisions And Should Apply To All Contracts*

In light of the foregoing, we believe it is important that the ADR discussion in the Proposed Advisory not be included in any final version — which in our view should focus exclusively on the very different subject of LoLs. (As noted above, this could include a reminder that LoLs that are included in ADR provisions should be evaluated in the same fashion as LoLs in other contexts.) Of course, if a final advisory is issued limited to LoLs, it would be helpful for the agencies to explain why the ADR discussion was deleted and to reaffirm their support for the use of ADR by financial institutions.

Nonetheless, if ADR is to be addressed in a final advisory, we submit that the focus should be on making sure that ADR provisions are commercially reasonable. Such guidance should apply to all contracts entered into by financial institutions, not just audit engagement letters, and should incorporate the following principles:

- ADR provisions should apply equally to both parties;

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21 AICPA Ethics Ruling No. 95, ET 191.190-191 (revised July 2002). AICPA Ethics Rulings in effect as of April 16, 2003 were adopted by the Public Company Accounting Oversight Board as part of its Interim Rules 3500T and 3600T.

22 *See* FDIC, *Statement of Policy on Use of Binding Arbitration, supra* note 15.

- ADR provisions should provide a fair process as noted in Supreme Court precedent (*e.g.*, neutral decision-makers and an appropriate hearing procedure);
- ADR provisions should not be imposed in a coercive manner. (Indeed, ADR agreements entered into under coercion are unenforceable under basic contract law.)

ADR agreements that honor these fundamental due process considerations, we submit, are fully consistent with safety and soundness. They satisfy the parties' desire to resolve disputes in an alternative forum, and by doing so they help to relieve stress on our overburdened courts. In accordance with federal policy, such agreements should be encouraged, not discouraged.

## B. The Proposed Advisory Should Permit LoL Provisions That Do Not Pose A Risk Of Loss To The Financial Institution, Such As Mutual Waivers Of Punitive Damages

Just as the Proposed Advisory should not place ADR provisions in the same category as LoL provisions, we submit that it should allow for appropriate distinctions among LoL provisions. Although some such provisions might arguably pose safety and soundness concerns, we submit that not all LoLs fall into this category.

In particular, we believe that the safety and soundness concerns do not apply to mutual waivers of punitive damages. Under such a provision, a financial institution and its auditor mutually agree that neither will seek punitive damages from the other. Each party remains fully liable for actual damages, *i.e.*, those that compensate the injured party for losses (including indirect and consequential losses) for which the other party is responsible.

Waiving punitive damages does not expose a financial institution to a risk of loss because, by their nature, punitive damages do not compensate for loss. Moreover, as explained below, we suggest that such a waiver has no impact on the conduct of audits, or the objectivity or impartiality with which audits must be performed. Further, mutual punitive damage waivers protect both auditors *and financial institutions* from unpredictable and potentially enormous punitive claims.

### 1. *LoL Provisions Vary Widely In Scope And Impact*

As defined in the Proposed Advisory, LoLs encompass a broad range of provisions that vary widely in scope and effect. Among these are:

- *Indemnification provisions,* under which a client undertakes to reimburse the auditor for liability the auditor may incur to third parties;
- *Release provisions,* under which the client gives up any right to sue the auditor for damages of any kind; and
- *Mutual waivers of punitive damages,* under which the client and the auditor agree that they will seek from one another only damages that compensate the injured party for actual loss caused by the other party.

U.S. Securities and Exchange Commission ("SEC") Staff guidance, cited in the Proposed Advisory, prohibits the use of *indemnification provisions* that seek to assure the accountant immunity from liability for the accountant's own negligent acts, as well as provisions that *release, indemnify, or hold harmless from any liability or costs resulting from knowing misrepresentations by management*.[23] The SEC Staff has expressed the view that if the auditor has entered into an indemnity agreement that seeks to provide an auditor "with immunity from liability for his own negligent acts, whether of omission or commission, one of the major stimuli to objective and unbiased consideration of the problems encountered in a particular engagement is removed or greatly weakened."[24]

The potential implications of the various provisions encompassed by the Proposed Advisory may differ significantly. For instance:

- *Indemnification provisions* and *releases from the consequences of knowing misrepresentations by management,* in combination, could potentially result in an auditor achieving immunity for liability from the consequences of any misconduct. Such a result would be clearly impermissible under the SEC Staff guidance.
- *Mutual waivers of punitive damages,* on the other hand, do not shield, limit or provide the auditor with immunity from any liability for losses caused by the auditor because punitive damages do not compensate for losses. Where a waiver of punitive damages is present, the auditor remains fully liable for actual damages (including consequential or indirect damages) incurred by the client as a result of an auditor's improper acts, whether of omission or commission. Further, and importantly, a waiver of punitive damages by the client has no bearing on damages that may be sought by a third party, such as a lender or shareholder, for such party's own losses. Third parties may seek damages of any type with respect to their own claims, including punitive damages.

### 2. *Mutual Waivers Of Punitive Damages Are Consistent With Safety And Soundness*

We suggest that mutual waivers of punitive damages are fully consistent with safety and soundness and should, therefore, be permitted.

*First,* waiving punitive damages does not expose a financial institution to a risk of loss. As noted above, punitive damages, by definition, are not compensation for losses suffered. They go beyond what is needed to make a party whole.

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[23] See SEC Office of the Chief Accountant, *Application of the Commission's Rules on Auditor Independence, Frequently Asked Questions* (Dec. 13, 2004), *cited in* 70 Fed. Reg. at 24581.

[24] Codification of Financial Reporting Policies § 602.02.f.i, *cited in* 70 Fed. Reg. at 24580. AICPA independence standards also address indemnification provisions as opposed to other types of provisions that may be encompassed in the Proposed Advisory's concept of LoLs. The AICPA standards generally prohibit indemnification; however, they do permit agreements in which a client agrees to indemnify the auditor for knowing misrepresentations by management. *See id.* at 24579 n.8.

*Second,* a mutual waiver of punitive damages can help to protect both financial institutions and their auditors from the threat of catastrophic liability. Punitive awards are notorious for their unpredictability and potential size. In the financial context, where actual damages can run into the hundreds of millions of dollars, a punitive award could be many times that amount.[25] It is not surprising that business groups frequently argue that punitive damages should be limited or abolished, and that mutual waivers by business entities are widespread.

*Third*, we do not believe that removing the possibility of a punitive award has any adverse effect on audit objectivity or impartiality. As noted above, a waiver of punitive damages does not protect an auditor from liability to the financial institution for losses caused by the auditor's actions, and the auditor remains liable for *all* damages as to claims belonging to third parties.

Further, it is difficult to see how the objectivity or impartiality of an audit could turn on the extent of civil liability, given the significant differences in liability rules from one jurisdiction to another. For instance, the availability of punitive damages varies considerably from state to state: most provide no clear limits, some take a middle ground approach, and a few generally prohibit such damages altogether.[26] We are not aware of evidence to suggest that audit quality rises or falls depending upon such variations in the law. If the laws governing auditor liability can vary without affecting audit objectivity and impartiality, it is hard to conclude that contractual provisions with the same objective could, or would, have any different effect.

In any case, the comprehensive system of regulation, oversight and professional discipline of the accounting profession provides significant safeguards for proper auditing, quite apart from whether punitive damages are available. For example:

- Auditors are subject to professional auditing standards.
- Audit firms are regularly inspected by the Public Company Accounting Oversight Board ("PCAOB") and are subject to peer review under the rules of the American Institute of Certified Public Accountants ("AICPA") and state laws.[27]
- Auditors are subject to oversight and discipline — including being barred from practice for improper conduct — by the SEC, the PCAOB, the AICPA, and state authori-

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[25] Although the Supreme Court held that there is some due process limit on the size of punitive damage awards, *State Farm Mutual Auto. Ins. Co. v. Campbell*, 538 U.S. 408 (2003), the Court has not precluded awards of as much as several times actual damages. *See id.* at 425.

[26] For instance, punitive damages are generally not available in Massachusetts, New Hampshire and Washington, and are capped at a few hundred thousand dollars in Georgia and Virginia. *Riley v. Harr,* 292 F.3d 282, 300 n.15 (1st Cir. 2002) (New Hampshire); *Lowell v. Massachusetts Bonding & Ins. Co.*, 47 N.E. 2d 265, 272 (Mass. 1943); *Dailey v. North Coast Life Ins. Co.*, 919 P.2d 589, 590 (Wash. 1996); O.C.G.A. § 51-12-5.1(g); Va. Code Ann. § 8.01-38.1.

[27] *See* 15 U.S.C. § 7211(c)(3); Uniform Accountancy Act § 7(h) (3d ed. Nov. 2002) ("UAA"); David Jenthro & Dean Beddow, *Peer Review is Stronger and Better Now,* J. Accountancy Online (April 2005).

- ties.[28] The type of extreme conduct that could justify a punitive damages award would certainly prompt appropriate action by one of a number of regulators.
- Regulators have access to all work performed by auditors, and auditors who engage in improper conduct can be barred from the industry for "good cause."[29]

As noted above, an auditor's conduct must be particularly egregious to justify a punitive damage award. Such conduct would subject the auditor to a host of administrative or regulatory sanctions. There is no evidence in the Proposed Advisory to support the view that the possibility of a punitive damage award would have any added deterrent effect.

For all of these reasons, we submit that the Proposed Advisory should distinguish between LoL provisions that would eliminate liability for actual damages and those that do not. We suggest that that mutual waivers of punitive damages, in particular, should be permitted.

C. The Agencies Should Carefully Consider The Potential Consequences Of Limiting The Ability Of Auditors To Manage Risk By Contract

We suggest that FFIEC and the agencies may want to consider the potential consequences that could follow if the Proposed Advisory is adopted. In our view, limiting the ability of financial institutions to enter into ADR and LoL provisions with their external auditors could have the unintended and counterproductive consequence of making it more difficult, or at least more expensive, for some financial institutions to obtain audit services.

In today's world, accounting firms face very significant liability concerns. They can potentially face civil liability of hundreds of millions of dollars — in some cases, even *billions* of dollars — arising out of an engagement that generated only a tiny fraction of that amount in fees. In many cases, even the transaction costs of litigation such as attorney's fees, expert witness expenses, and discovery costs can vastly exceed the revenues generated by an engagement. Of course, audit quality is a critical element of managing risk, and external auditors must at all times be mindful of their responsibility to be objective and impartial. But within the context of their professional obligations, auditors may also look at other methods, such as risk-based pricing, client selection, and contractual protections, as would any enterprise seeking to keep risk commensurate with expected return.

Contract provisions providing for ADR and LoLs can be valuable tools in managing an auditor's financial risk. Although ADR provisions do not affect liability, they may help to control litigation costs. LoL provisions, in turn, can help somewhat in keeping liability risk manageable. A punitive damages waiver, for instance, protects the auditor against the possibility of a runaway award that, as noted, could increase the auditor's potential liability many fold.

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28 *See* 15 U.S.C. §§ 7211(c)(4) and 7215 *et seq.*; 17 C.F.R. § 201.102(e) ; UAA § 10(a); AICPA Joint Ethics Enforcement Program, Manual of Procedures § 4.14 (2004).

29 *See* 12 C.F.R. §§ 19, 263, 308, 513.

Because auditors' risks are higher when serving weaker financial institutions, the Proposed Advisory might make it harder, or more expensive, for such institutions to obtain audit services. Such a result would appear inconsistent with the agencies' safety and soundness goals.

## IV. Responses To Certain Specific Requests For Comments

The Proposed Advisory posed several specific areas in which FFIEC is seeking comments. We have addressed some of these areas in the discussion above.[30] Below, we provide our responses to certain additional questions.

*Question 1* inquires about the scope of the Proposed Advisory's application, including whether it should apply to all financial institutions, regardless of their regulatory status, and whether it should apply to voluntary audit engagements. We believe that the standards concerning audit engagement agreements with financial institutions should apply to all audits, regardless of the financial institution's size or the voluntary nature of the audit.[31] Auditors are bound by professional standards in every audit, irrespective of the size of the client or whether the engagement is voluntary rather than required.

*Questions 4 and 5* inquire as to the clarity of the Proposed Advisory's descriptions of the categories of disfavored LoLs, as well as the examples provided in Appendix A to the Proposed Advisory. As currently drafted, the Proposed Advisory suggests that *all* LoL provisions are prohibited; thus, the examples given are not especially useful. To the extent that the Proposed Advisory is revised to apply only to certain types of LoL provisions, it could be helpful to categorize the disfavored provisions in relation to the harm they are trying to prevent, and to explain why each provision is considered to be unsafe or unsound.

*Question 7* asks for comments on the Proposed Advisory's suggestion that financial institutions take appropriate action to nullify LoL provisions in 2005 audit engagement letters that have already been executed. Given that the Proposed Advisory presents no evidence of an existing or imminent safety and soundness threat, we do not see a basis for an "*ex post facto*" rule seeking, in effect, to impair existing contractual obligations.

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We hope that the agencies find these comments useful. In view of the substantive concerns set forth herein, we respectfully request the opportunity to meet with the agencies to discuss the Proposed Advisory.

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[30] Questions 2 and 3 are addressed in Part III C, and Question 6 is addressed in Part III B.

[31] The Purpose section of the Proposed Advisory states that it "applies to any agreement that a financial institution enters into with its external auditor that limits the external auditor's liability with respect to financial statement audits." 70 Fed. Reg. at 24577. At various points, however, the Proposed Advisory is less clear on this point, referring more generally to "agreements," "written engagement letters" or "arrangements." We suggest that the scope should be as stated in the Purpose section and that consistent language be employed throughout to avoid possible ambiguity.

If you have any questions regarding the matters discussed in this letter, please contact any of the following individuals in our Financial Services Office: Stephen R. Howe, Jr., Managing Partner, at 212-773-3258; Carmine DiSibio, Managing Partner – Assurance and Advisory Business Services, at 212-773-1673; or Richard L. Brezovec, Professional Practice Director, at 212-773-3267.

Sincerely,

Ernst & Young LLP